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SUBJECT: BRAZIL: July 11, 2007, meeting between U.S. Treasury Secretary Paulson and Central Bank President Meirelles

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¶1. (SBU) Summary: In their July 11 Brasilia meeting, Central Bank President Henrique Meirelles told Secretary Paulson that Brazil appears to have overcome the extreme economic and financial volatility it experienced in the past, and that Brazil's medium-term growth and inflation outlook is positive. The recent improvement in Brazil's economic performance is partly attributable to favorable global economic growth, but is also attributable to Brazil's strong fiscal and monetary policy performance as well as the reduction in its external financial vulnerabilities. The strong appreciation of the Brazilian real that has occurred in recent months reflects the improvement in Brazil's economic fundamentals in addition to recent credit rating agency upgrades of Brazil's sovereign debt. End Summary.

¶2. (SBU) Meirelles opened the meeting by providing an overview of Brazil's economic history over the past decade and also its current economic outlook. Meirelles stated that Brazil has historically suffered from "stop-and-go," boom-and-bust economic cycles largely as a result of three factors: (1) erratic balance of payments performance, (2) poor fiscal policy and resulting pressures for monetary financing from the central bank that led to high and volatile inflation, and (3) the extensive use of controls and regulations rather than price and market mechanisms to allocate economic resources, which increased the size of Brazil's public sector and slowed private sector development in Brazil.

¶3. (SBU) Meirelles stated that the adoption of the Plano Real in 1994 was an important, but incomplete, step in Brazil's transition toward economic stabilization. The Plano Real successfully ended Brazil's hyperinflation. However, it did not address underlying problems in Brazil's fiscal and balance of payments performance. Largely as a result of Brazil's poor fiscal performance after 1994, it suffered crises in 1998-99 and again in 2002. Meirelles stated that it was only after all three factors came together in 2003-04 - lower inflation, improved fiscal policy, and stronger trade performance - did Brazil's economic performance begin to improve measurably. Provided these factors continue, Brazil's growth should be much more sustainable in the future than it has been in the past.

¶4. (SBU) Although Meirelles attributed some of Brazil's improved performance in recent years to favorable global economic conditions, he stated that Brazil has successfully leveraged benign global conditions to implement reforms and improve public and private sector balance sheets (for example, eliminating net external public sector debt). Brazil's Central Bank is currently forecasting 4.7% growth for calendar year 2007 (slightly higher than most private sector forecasts). Personal consumption spending is expanding by 8% (annualized), and investment is growing even more rapidly (rate not specified). In contrast to Brazil's previous growth cycles, net exports are now negative net contributors to Brazil's growth. Inflation over the next three years is forecast to be in line with the central bank's annual target (4.5%).

¶5. (SBU) Meirelles stated that Brazil's improved macroeconomic outlook has had positive spillover effects on private sector investment. Low and stable inflation has helped to reduce risk premia and allowed private sector investors to project cash flows over much longer time horizons, supporting faster growth in investment spending. Domestic credit is currently expanding by 20% (annualized). Brazil's domestic credit-to-GDP ratio has climbed from 21% in 2002 to 32% in 2007.

¶6. (SBU) Meirelles stated that the strong appreciation of the Brazilian real (from 3.8/USD in 2002 to 1.89/USD at present) has forced a "painful but necessary restructuring process on some industries," and that currency appreciation has been an important catalyst for some Brazilian industries to significantly improve their global competitiveness.

¶7. (SBU) Secretary Paulson provided an overview of the global and the U.S. economic outlook. He stated that he has never observed such favorable global economic conditions as currently exist and that the global economy is now "awash in cash." He stated that he is not predicting a crisis, but that he also believes such favorable global

conditions will not persist indefinitely. He reported that growth prospects in many regions, especially in East Asia, remain strong.

¶8. (SBU) Discussing the U.S. economy, Secretary Paulson stated that the outlook appears strong, that most sectors of the economy are in good shape, and that the U.S. economy appears flexible and resilient to most potential shocks it could experience. He stated that the U.S. fiscal deficit (currently forecast for FY 2007 to be equivalent to 1.5% of GDP) has surprised many people on the upside due to stronger-than-expected revenue growth. Revenues are currently 18.4% of GDP - consistent with the long-term U.S. historical average. Secretary Paulson stated that key factor for continued U.S. growth

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is to ensure that inflation does not rise, which would force the Federal Reserve to tighten monetary policy quickly and in a way that might harm confidence and private sector spending.

¶9. (SBU) Secretary Paulson stated that difficulties in the sub-prime housing market were fairly predictable as a result of the extended liquidity buildup in U.S. real estate and the aggressiveness of U.S. lenders. He stated that he believes that conditions in the sub-prime market have probably bottomed out, but that the effects in this market may persist for some time as banks work through these non-performing loans. He said that sub-prime is a controversial political issue in the U.S., but he believes the economic impact of sub-prime housing market difficulties on the U.S. macroeconomy will be limited.

¶10. (SBU) Discussing exchange rates, Secretary Paulson noted the importance of allowing exchange rates to be market-determined. Although he believes a strong dollar is in the U.S. national economic interest, he also believes market forces should determine foreign exchange rates and does not support efforts by some countries - notably China - to manage their exchange rates in a rigid manner. He noted that it would be helpful if Brazilian officials communicated this message in their discussions with China's leaders.

¶11. (SBU) In response to a question asked by Paulo Vieira da Cunha (Director of International Affairs) about the potential risk posed by global hedge funds, Secretary Paulson stated that hedge funds have provided many important benefits to the global economy but that he is concerned about possible risks they might create due to their extensive use of financial leverage. Secretary Paulson currently chairs an inter-agency working group (Treasury, Federal Reserve, the Securities and Exchange Commission, and the Commodities Futures Trading Commission) that is examining potential systemic risks that might emanate from hedge funds. He stated that he believes imposing new regulations to limit hedge fund risk is likely to be ineffective, and instead prefers an alternative approach that emphasizes the importance of improved transparency, greater disclosure, and the implementation of best financial practices by hedge funds.

¶12. (SBU) Secretary Paulson stated that he does not believe global current account imbalances are likely to be resolved through exchange rate movements. Although currency adjustments can be helpful in correcting external imbalances, the deeper and more important source of these imbalances lie in structural factors at work within larger economies. In particular, Secretary Paulson noted the high degree of precautionary saving that exists in China due to the lack of adequate social insurance mechanisms and the shallow capital markets there that force many firms to finance investment spending via retained earnings rather than through external borrowing.

¶13. (SBU) In response to a question about U.S. fiscal performance asked by Mario Mesquita (Director of Economic Policy), Secretary Paulson stated that the key fiscal challenge the U.S. faces is medium-term rather than short-term. Recent short-term U.S. fiscal performance has exceeded most forecasts. However, the U.S. has not effectively addressed medium-term challenges it faces in reforming health care and social security spending. He stated that these problems are not analytically difficult, but that building a political consensus on the reforms needed to ensure the long-term solvency of these programs has proven difficult.

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